THE BOND BUYER

Dealers face compliance challenges in coronavirus-impacted market

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Nearly unprecedented price volatility the past two weeks has caused a compliance challenge for broker-dealer firms as they try to keep pace with the market.

More preliminary official statements point to a reopening of the primary market after a two-week standstill, but dealers said those past few weeks posed a significant challenge with respect to regulations aimed at making sure they get good prices for their customers.

Market dislocation between primary and secondary has been unprecedented, said SIFMA's Leslie Norwood.

“This market dislocation is really unprecedented,” said Leslie Norwood, managing director, associate general counsel and head of municipals at the Securities Industry and Financial Markets Association. “The volatility in the muni market is even more dramatic than previous periods of volatility, and since the implementation of the Municipal Securities Rulemaking Board’s best execution rule, there really hasn’t been any event that caused firms to implement their extreme market condition exemptions for the best execution rule on a marketwide basis. Maybe they’ve done it in respect to certain securities, but not on a marketwide basis.”

Benchmark yields swung between 50 to 60 to 75 basis points in either direction over the course of two weeks, first correcting higher and then falling sharply this week. The market had to attempt to calibrate yields and spreads during that time. There has been a 75% jump in average daily volume, running at $28 billion traded per day vs. $16 billion in the first week of the month.

The MSRB's best execution rule, which took effect in 2016, requires that a dealer must use "reasonable diligence" to find the best market for a security to get the best price for a customer possible under the market conditions.

Additional disclosures have been made to investors to make them aware of extreme market conditions, Norwood said.

Market movements caused by COVID-19 can be challenging for compliance personnel not only because there is more volume than normal, but also it requires a percentage of trades to have additional documentation, Norwood said.

Markup disclosure has also been a challenge for dealers. As of 2018, dealers have to disclose markups and markdowns on certain transactions in the confirmations they send to retail customers. Those have to be disclosed as both a total dollar amount and as a percentage of the prevailing market price, commonly referred to as the "PMP."

The rule prescribes a "waterfall" of factors for determining the PMP, beginning with contemporaneous trades of the same security and followed by a series of other considerations.

The prevailing market price waterfall has made compliance with markup disclosure challenging, contemporaneous with fluctuations in basis points, Norwood said.

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"There have been some challenges with that and concerns about investors who are looking at those disclosures on their confirmations and not necessarily appreciating the market conditions during which the disclosures were made," Norwood said.

Trading patterns have changed significantly over the last few weeks. Analysts say investors are reacting to changes in the market by increasing their redemption demands to raise cash. Mutual funds are then having to sell bonds to pay those clients.

“Traders have scrambled to keep up and with the incredible selling pressure so there was a lot of forced selling, which led to potential mismatched prices,” a New York strategist said. “Vendors were also struggling to keep up with the massive swings in benchmark rates. This is not to say that there was anything nefarious going on — it's simply that during volatile times, the municipal market struggles to keep pace due to antiquated models and a lack of uniform technologies."

Compliance has also challenged a few Bond Dealers of America- affiliated firms.

Dealers are seeing bids from the same dealers change as much as 10 points day-over-day for the same bonds, then re-offered to the market five or 10 points or more higher, a head of retail fixed-income trading said.

“Will regulators understand and appreciate the positions dealers are taking now, during volatile stressful markets?” they said. “Our experience has been ‘no,’ there is very little consideration and understanding for how market conditions drives trading and market making for clients.”

Another head of fixed income at a BDA firm said once any bid emerges, dealers want others to justify other bids.

“That typically will not happen immediately in a race for liquidity,” they said. “The difficulty in determining Best Ex (best-execution) in a fast-moving market where you stand alone as the only participant and simply cannot rely on how ‘similar’ bonds are trading, or what an index reflects. That paralysis by analysis could stall a market.”

They also said regulators “should be happy” with transparency results.

“Immediately posted prices helped calm the nerves of many investors and sellers,” they said. “Those that needed the immediate liquidity got it — albeit at a premium. But, it successfully accomplished their need.”